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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**HEARING SUMMARY**
	PERSONAL INCOME TAX APPEAL
DENNIS A. CONFORTO AND	Case Nos. 522443, 528754[1]
BONNY J. CONFORTO	

Years	Proposed Assessment[2]	Claim for Refund
2001	$53,661	
2003		$28,733

Representing the Parties:

For Appellants: Paul W. Rowe, Attorney at Law

For Franchise Tax Board: Raul A. Escatel, Tax Counsel

QUESTIONS: (1) Whether appellants have shown that their shares of stock in Shop A-Z.com Inc. (Shop A-Z.com) became worthless in 2001.

[1] This appeal was postponed at the request of appellants from the June 21, 2011 oral hearing calendar because of a scheduling conflict.

[2] The Franchise Tax Board (FTB or respondent) has imposed under Revenue and Taxation Code (R&TC) section 19777.5 a post-amnesty penalty of $3,247.43 against appellants for 2001. The post-amnesty penalty is not at issue but would be removed if appellants prevail on the main issue. Otherwise, R&TC section 19777.5, subdivision (e), indicates that the only relief available to appellants would be to file a claim for refund of the penalty and prove that respondent improperly computed its amount.

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(2) Whether appellants are entitled to carry over to 2003 a portion of the capital loss that they allegedly experienced as the result of their Shop A-Z.com stock becoming worthless in 2001.

HEARING SUMMARY

Background

Shop A-Z.com, an on-line retailer of a wide variety of products, was incorporated during 1999. Appellant[3] was the founder and Chief Executive Officer (CEO) of Shop A-Z.com. During 1999, appellant was the owner of 99.95 percent of the shares of stock of that company. Subsequently, appellant owned 79.04 percent of the shares of stock of the company during 2000 and 79 percent of those shares during 2001 through 2003. Shop A-Z.com filed California corporate tax returns for each year from 1999 through 2004. In 2004, Shop A-Z.com applied for dissolution with the California Secretary of State, and its return for 2004 was the last California corporate tax return that it filed.

Respondent examined each of appellant's California tax returns from 2000 through 2004. On his 2001 federal tax return, appellant reported a business loss of $2,458,017. After taking into account capital gain of $391,116 and other income, appellant reported on that return federal adjusted gross income of negative $1,835,367. Appellant correspondingly reported negative $1,835,367 as federal adjusted gross income on his 2001 California return. After taking into account deductions of $5,920, appellant reported zero California taxable income on that return. On Form 3805V of the return, appellant reported, after multiplying $1,841,287 by 55 percent, a 2001 net operating loss (NOL) carryover of $1,012,708.[4]

After reviewing the returns of Shop A-Z.com for 1999 through 2004, as well as

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[3] Appellant-wife is a party in this matter only because she executed joint California resident tax returns for the appeal years. For ease of reference, this hearing summary will often discuss only appellant-husband when it would otherwise have been appropriate to discuss both appellants and will generally refer to him as "appellant."

[4] Respondent states that, of his total business loss of $2,458,017 for 2001, appellant carried over an NOL of $1,841,287 to 2002. Respondent states further that because California had suspended NOL deductions for 2002 and 2003, appellant carried over from 2001 an NOL of $167,241 to be used in 2004 and the remaining NOL of $1,674,046 to 2005. (Resp. Br. for 2001, p. 2.) Staff notes that respondent's account of appellant's treatment of his California NOL for 2001 is inconsistent with both the information on appellant's Form 3805V for 2001 (Resp. Br. for 2001, p. 4 of Exhibit A) and R&TC section 17276, subdivision (b)(1)(B). R&TC section 17276, subdivision (b)(1)(B), limits the amount of an NOL for 2001 that may be carried over to subsequent years to 55 percent of the NOL.

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documentary evidence provided by appellant, respondent concluded, among other conclusions that it drew, that the business loss of $2,458,017 reported by appellant on his 2001 federal return represented cash advances from appellant to the company that were capital contributions rather than loans. Respondent further concluded that appellant's interest in the company did not become worthless until 2004 as a result of its filing for dissolution with the California Secretary of State. As a result of its review and the conclusions that it drew, respondent issued Notices of Proposed Assessment (NPA's) against appellant for 2000, 2001, and 2004. In its NPA for 2001 (Resp. Br. for 2001, pp. 3-4 of Exhibit C), issued on July 7, 2006, respondent characterized appellant's reported income for 2001 as a negative $1,841,287, disallowed a claimed business bad debt of $2,458,017, and determined that his revised taxable income for 2001 was $616,730.[5] In addition, respondent justified the disallowance of the claimed business bad debt on the basis that appellant did not show that the amount at issue was uncollectible or "became worthless" during 2001.

Appellant protested the NPA's for 2001 and 2004. At protest, appellant argued that the cash advances that he made to Shop A-Z.com were true loans rather than capital contributions and that those loans became worthless during 2001. During the protest period, appellant also filed an amended return for 2003 that claimed a refund of $28,733. In a cover letter dated March 4, 2008, that accompanied appellant's 2003 amended return, appellant's representative explained that appellant was filing the amended return as a protective refund claim in the event that the business loss claimed by appellant for 2001 was not an NOL but rather was a capital loss that could be carried forward to 2003 and generate a refund of $28,733. (Resp. Br. for 2001, p. 4 of Exhibit D.) In a Notice of Action (NOA) dated December 30, 2009, respondent affirmed its NPA for 2001. Respondent determined that appellant's claimed bad debt deduction for 2001 should be disallowed. Respondent further determined that appellant's advances to Shop A-Z.com were contributions to capital and that the year they became worthless was 2004, the year that the corporation ceased doing business. In a letter to appellant of the same date, respondent also denied appellant's refund claim for 2003. Respondent states that appellant's protective refund claim for 2003 was denied because appellant's advances were capital contributions

[5] Staff notes that lines 12 and 15 on appellant's Form 3805V (Resp. Br. for 2001, p. 4 of Exhibit A) for 2001 are consistent with respondent's determination of his revised taxable income for that year.

that became worthless in 2004 rather than in 2001. Respondent states in its letter that "[t]he capital loss determined at protest was allowed in 2004, but did not result in a reduction of tax or refund." (App. Ltr. for 2003, Attachment.) Appellant timely appealed both respondent's NOA for 2001 and its denial of appellant's refund claim for 2003. Both appeals were consolidated, without objection, for hearing and decision.

Contentions

Appellant concedes on appeal that the amount of $2,458,243 he advanced to Shop A-Z.com were capital contributions to the corporation rather than loans. However, appellant contends that he should be permitted to deduct that amount in 2001 because his shares of stock in Shop A-Z.com became worthless during that year. In support of his contention, appellant cites *Steadman v. Commissioner* (*Steadman*) (1968) 50 T.C. 369, affd. (6th Cir. 1970) 424 F.2d 1. The Tax Court in *Steadman* agreed with the taxpayer there that certain of his shares of stock in a corporation became worthless in 1962 rather than in 1964 when the corporation was declared bankrupt. The Tax Court held that, in 1962, there was no reasonable expectation of future profit to the corporation and that a prudent businessman would have ascertained the stock to be worthless in that year. (*Steadman v. Commissioner*, *supra*, 50 T.C. at p. 377.) In reaching its holding, the Tax Court emphasized a devastating loss incurred by the corporation during 1962, the complete inadequacy of its capitalization, and the inefficiency in the manufacture and sale of its products. (*Steadman v. Commissioner*, *supra*, 50 T.C. at p. 378.)

Appellant argues that because the circumstances confronting Shop A-Z.com were allegedly more severe than those facing the corporation in *Steadman*, no prudent businessman could hope or expect that continuation of the business of Shop A-Z.com beyond 2001 would ever yield any profit for its shareholders. Appellant states that the corporation in *Steadman* had an NOL in excess of $1.3 million while Shop A-Z.com had an NOL in excess of $2.9 million at the end of 2001. Appellant also states that the excess of current liabilities over current assets for the corporation in *Steadman* was over $100,000 while that excess for Shop A-Z.com at the end of 2001 was in excess of $670,000. In addition, appellant states that the net deficit in shareholder equity in *Steadman* was $456,109.19 while the net deficit in shareholder equity of Shop A-Z.com at the end of 2001 was within a range between $295,002 and $820,027. Appellant argues that the larger of the foregoing two amounts should be

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applicable because an undefined intangible asset of Shop A-Z.com denominated "dot.com domain names," which appellant characterizes as the company's most significant asset, should be valued at zero rather than at its original purchase price of $525,025.[6] In his conclusion, appellant urges that the unfavorable financial circumstances of Shop A-Z.com be considered in light of the "dot.com" bust that occurred in 2001 and 2002.

Respondent contends that appellant is not entitled to a worthless stock deduction under Internal Revenue Code (IRC) 165 for 2001 because he has not proven that his stock in Shop A-Z.com became worthless during that year. Citing *Boesel v. Commissioner* (2nd Cir. 1954) 208 F.2d 817, 819 for the proposition that a taxpayer must show by an identifiable event, or identifiable events, that a claimed loss was actually sustained during the taxable period and that a mere subjective conclusion by the taxpayer that the loss took place during that period will not suffice, respondent argues that appellant has not provided adequate evidence that appellant's stock in Shop A-Z.com became worthless during 2001. In fact, respondent states that the evidence in the record now indicates that the stock may never have become worthless. After a review of various websites, respondent has concluded that, as the result of a result of a merger, Shop A-Z.com became part of A-Z Media Group and may still continue to operate as before. Appellant is apparently the founder and CEO of A-Z Media Group. (Resp. Br. for 2001, pp. 5-6.)

Respondent also argues that, in any event, appellant may not prevail under *Steadman* with regard to 2001 because the facts in that case are distinguishable from those in the instant matter. Respondent contrasts the failing financial health of the company in *Steadman* in the years after 1962, the year in which the stock in that company was declared worthless, with what it essentially characterizes as the ever improving financial health of Shop A-Z.com from 2000 through 2004. (See Resp. Br. for 2001, pp. 1-2, 7-8.) Respondent also states that appellant's comparison of the NOL of the corporation in *Steadman* with that of Shop A-Z.com is misleading because of the difference in the value of currency

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[6] Appellant also argues that if the Board accepts respondent's position that appellant only contributed $1,540,067 to Shop A-Z.com, rather than $2,458,243, each figure in the range of the net deficit in shareholder equity should be increased by $918,176 ($2,458,243-$1,540,067). Respondent states in its opening brief that it determined from documentation provided at audit that appellant contributed the smaller amount, but neither party has provided the alleged documentation. (Resp. Br. for 2001, p. 1.)

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between 1962 and 2001. Finally, respondent contrasts the emphasis that the Tax Court in *Steadman* placed on the inadequacy of the capitalization of the company there and its poor prospects for sales and modernization of its manufacturing equipment with appellant's alleged failure to claim that Shop A-Z.com was in similarly dire condition.

With regard to 2003, appellant contends that he is entitled to a refund of $28,733. In support of that contention, appellant argues, without citation to authority, that as a result of his stock in Shop A-Z.com becoming worthless in 2001, he may carry over to 2003 part of the resulting capital loss. Respondent argues that it cannot be determined whether appellant is entitled to carry over to 2004 any part of such an alleged loss until it is first determined whether appellant's stock in Shop A-Z.com actually became worthless in 2001.

Applicable Law

R&TC section 17201, subdivision (a), incorporates by reference IRC section 165, except as otherwise provided. IRC section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. IRC section 165(g)(1) provides that if any security that is a capital asset becomes worthless during the taxable year, the loss resulting loss shall be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. The taxpayer has the burden of proving that the security had value at the beginning of the taxable year and that it was rendered worthless, with no liquidating or potential value, during that year. (See *Franklin E. and Suzanne H. Scudder*, 87-SBE-059, Jul. 28, 1987 (citing *Boehm v. Commissioner* (1945) 326 U.S. 287).)

In *Steadman*, the Tax Court stated that the taxpayer had the burden of proving that, in 1962, the corporation's stock ceased to have both liquidating value, an excess of assets over liabilities, and potential value, a reasonable expectation that the assts would exceed the liabilities in the future. (*Steadman v. Commissioner*, *supra*, 50 T.C. at p. 376.) It stated further that this burden is generally met by pointing to an "identifiable event" in the life of the corporation that is normally considered as effectively destroying the potential value, such as cessation of normal business operations or bankruptcy. (*Steadman v. Commissioner*, *supra*, 50 T.C. at p. 377.) However, the Tax Court also quoted with approval the following language from *Sterling Morton* (1938) B.T.A 1270, 1279:

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> There are, however, exceptional cases where the liabilities of a corporation are so greatly in excess of its assets and the nature of its assets and business is such that there is no reasonable hope and expectation that a continuation of the business will result in any profit to its shareholders. In such cases the stock, obviously, has no liquidating value, and since the limits of the corporation's future are fixed, the stock, likewise, can presently be said to have no potential value. Where both these factors are established, the occurrence in a later year of an "identifiable event" in the corporation's life, such as liquidation or receivership, will not, therefore, determine the worthlessness of the stock, for already "its value has become finally extinct."

(*Steadman v. Commissioner*, *supra*.)

In affirming the Tax Court, the federal court of appeals noted that the question of when stock become worthless involves a finding of fact and that the Tax Court's holding that the stock at issue became worthless in 1962 was supported by substantial evidence. (*Steadman v. Commissioner*, *supra*, 421 F.2d at pp. 3-4.)

It is well settled that deductions are a matter of legislative grace and that the taxpayer bears the burden of establishing his entitlement to the claimed deduction. (*Appeal of Robert R. Telles*, 86-SBE-061, Mar. 6, 1986.) In order to carry that burden, the taxpayer must point to a statute and show by credible evidence that he comes within its terms. Unsubstantiated assertions by the taxpayer are not sufficient to carry the burden of proof. (*Appeal of Robert R. Telles*, *supra*.) It is also well settled that the failure of a party to provide evidence that is within his control gives rise to the presumption that, if provided, it would be unfavorable. (*Appeal of Don A. Cookston*, 83-SBE-048, Jan. 3, 1983.) In a refund action, the taxpayer must prove not only that respondent's determination of his tax liability is incorrect but also the correct amount of the tax that he owes. (*Appeal of Edward Durley*, 82-SBE-154, Jul. 26, 1982.)

R&TC section 17276, subdivision (a), states that, except as provided in certain other sections of the R&TC, the deduction provided by IRC section 172, relating to a net operating loss deduction, shall be modified as follows: (1) net operating losses attributable to taxable years beginning before January 1, 1987, shall not be allowed and (2) a net operating loss shall not be carried forward to any taxable year beginning before January 1, 1987. IRC section 172(a) states, in pertinent part, that there shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryover to such year and (2) the net operating loss carrybacks to such year. R&TC section 17276, subdivision (b)(1)(B), provides generally that the provisions of IRC section 172(b)(2),

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relating to the amount of carryovers, shall be modified so that 55 percent of the entire amount of the operating loss for any taxable year beginning on or after January 1, 2000, and before January 1, 2002, shall be eligible for carryover to any subsequent taxable year.

STAFF COMMENTS

The parties should be prepared to discuss at the hearing whether Shop A-Z.com, or any component of it, continues to operate as part of the A-Z Media Group. In that regard, appellants should provide before the hearing any documentation indicating that a merger or other reorganization, or a purchase and sale of stock or assets, occurred involving Shop A-Z.com and any other member of the A-Z Media Group. If Shop A-Z.com continues to operate in any form or manner, appellants should be prepared to explain those operations and the form in which it continues to operate.

Appellants should be prepared to advance relevant legal arguments that they are entitled to carry over to 2003 any part of a loss that the Board determines that they incurred during 2001. Appellants should also be prepared to prove the amount of the loss which they claim they are entitled to carry over to 2003.

Appellants should send the documentation, with a copy to respondent, to the following address at least 14 days before the date of the hearing:

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